

**A Lesson
From Detroit:**
**Ways to Make
Municipal
Bankruptcy
More Rare and
Less Painful**

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It is often said that government should be run like a business, making sure that its expenses do not exceed its revenues and resolving its financial choices rationally, with an eye toward efficiency. As a practical matter, it can be difficult for cities to achieve this ideal, especially because economically rational decision-making is often difficult to maintain in the highly charged political climate of city government. In many situations, the economically rational choice is simply not politically possible. And even when political considerations do not preclude efficient choices, such choices can still be difficult to implement because cities often have much less financial flexibility than private enterprises. Because they make many long-term commitments to spending, such as bond financing for public projects, cities often cannot easily or quickly adjust their financial position when faced with unexpected economic developments that affect their revenue streams.

When cities are unable to balance their revenues and expenditures, for whatever reason, they are propelled into financial crisis. But the nature of the municipal financial crisis is another way in which city government is significantly different from a private business. Private enterprises can more easily use the bankruptcy process to respond to overwhelming financial problems, reorganizing their debt and, in many cases, restructuring their business operations so that they can survive going forward. While the municipal government does have access to the bankruptcy process under Chapter 9 of the Bankruptcy Code, municipal bankruptcy is a very different procedure than bankruptcy for a private actor. In particular, it can be very difficult for cities to use bankruptcy with the same facilities as private enterprise.

In recent years, as the financial crisis of 2008 wreaked havoc on many local economies, more cities were propelled into bankruptcy. The most notable and biggest of these municipal bankruptcies came in Detroit, which filed for Chapter 9 protection in 2013. The Detroit bankruptcy and others illustrate some of the unique and challenging problems arising in municipal bankruptcies. In particular, they demonstrate the problem of balancing the interests of competing municipal constituencies, particularly a city's employees and bondholders. This interest balancing can be complicated and difficult because state and federal law often make it harder for public entities to adjust their financial commitments to such constituencies.

This article surveys the problem of municipal bankruptcy and its recent manifestations, especially in Detroit. It concludes that the problem of financial distress in city government can be more effectively managed if state and city governments make more detailed plans and procedures for addressing municipal financial problems as they arise. Too often, state law regulates the financial operation of

cities without creating any intermediate steps between normal financial operation and bankruptcy. This article argues that the creation of such intermediate procedures and the establishment of overarching financial priorities can help to head off municipal financial problems before they metastasize and propel a city into bankruptcy court.

Part I of this article reviews the origin and basic parameters of Chapter 9, paying special attention to the ways in which the authority of state governments limits the ability of cities to seek bankruptcy protection. Part II discusses Detroit as a case study in municipal bankruptcy, particularly with respect to how the city was propelled into bankruptcy and to why the city's financial problems were so difficult to solve. In Part III, this article investigates legal reforms and approaches that help cities deal with their financial distress through something other than a bankruptcy filing.

Part I. The Basic Outlines of Chapter 9

The Legal Framework for Municipal Bankruptcy

Municipal bankruptcy exists in a legal realm governed by conflicting rules. The U.S. Constitution gives Congress a general power to establish "uniform laws on the subject of bankruptcies throughout the United States."¹ This authority, however, is limited because the Constitution also prevents federal power from intruding on the legal province of state government,² especially through the Tenth Amendment, which provides that "the powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are preserved to the states respectively, or to the people."³ When Congress first considered creating statutes that would permit municipal entities to declare bankruptcy, it was well aware of the risk that broad municipal bankruptcy powers could interfere with the right of states to control their internal affairs.⁴ Thus, the structure of Chapter

9 must be understood in terms of the need to balance the federal power to permit bankruptcy actions with the parallel power of the states to control the affairs of municipal entities, which are subdivisions of state government.⁵

The federal rules for municipal bankruptcy were established in 1934 when Congress enacted Chapter 9 of the United States Bankruptcy Code.⁶ The enactment of Chapter 9 was prompted by the exigencies of the Great Depression, especially the struggles of city governments to maintain their own fiscal health as their residents struggled to keep their heads above water during the nationwide economic decline.⁷ These struggles were acute; by 1936, more than 2,000 municipalities had defaulted on their debt obligations.⁸

In general, Chapter 9 gave the federal judiciary the authority to provide protection for financially distressed municipalities, so that those municipalities could continue to offer essential public services while adjusting their debt obligations.⁹ After it was first enacted, the Supreme Court ruled that Chapter 9 was unconstitutional because it intruded upon state sovereignty in violation of the Tenth Amendment.¹⁰ In 1937, Congress amended Chapter 9 to avoid the Tenth Amendment problems pointed out by the Supreme Court.¹¹ Chapter 9 was further amended after the fiscal crisis of New York City during the 1970s, eliminating the requirement that a debt readjustment plan could not be put into place until more than half of its creditors consented to it.¹² These amendments were designed to make it easier for large cities, like New York, to take advantage of Chapter 9 protections.¹³

Despite federal efforts to make it easier for cities to file for bankruptcy, very few municipalities actually seek Chapter 9 protection.¹⁴ To a great extent, this is because state governments still exercise their power under the Tenth Amendment to restrict their municipal subdivisions from entering bankruptcy.¹⁵ Only 12 states give cities the unconditional authority to file for bankruptcy; another dozen permit cities to file when certain conditions are met.¹⁶ Other states permit cities to file for bankruptcy, but they require that state government is involved in the process at some level.¹⁷ Georgia prohibits municipal bankruptcy altogether.¹⁸ Given these limitations, the recourse to municipal bankruptcy has been infrequent. During the past 60 years, only 63 cities, towns, or counties have sought Chapter 9 protection.¹⁹

The Requirements for Filing Municipal Bankruptcy

Aside from any conditions or restrictions imposed by state law, Chapter 9 itself imposes five requirements before a city can file its bankruptcy petition.²⁰ First, the entity must meet the Bankruptcy Code's definition of a "municipality," which is a "political subdivision or public agency or instrumentality of a state."²¹ Second, the municipality must demonstrate it is insolvent.²² According to the Bankruptcy Code, a municipality is "insolvent" if it is "generally not paying its debts as they become due" or it lacks the ability "to pay its debts as they become due."²³ Third, a municipality must have the authority to do so under its state's law.²⁴ The fourth and fifth requirements are designed to ensure that the municipality is acting in good faith.²⁵ Thus, the fourth requirement provides that the municipality must "desire[] to effect a plan to adjust [its] debts."²⁶ The purpose of this condition is to prevent the municipality from using the bankruptcy process solely as a means to delay the repayment of its creditors or to evade its repayment obligations altogether.²⁷ The fifth requirement mandates that the municipality must attempt to negotiate a debt readjustment plan with its creditors.²⁸

Once the municipality meets these five requirements, it can file a petition, which must be accompanied by a list of its creditors and a proposed debt reorganization plan.²⁹ If the bankruptcy court accepts the petition, the municipality receives the benefit of bankruptcy's automatic stay, which prevents the collection of any of the municipality's debt obligations during the pendency of the bankruptcy proceedings.³⁰ After the bankruptcy court confirms the final debt readjustment plan, usually after negotiations between the municipality and creditors and legal rulings by the court, the municipality is discharged from bankruptcy.³¹

The Costs and Benefits of Chapter 9

The first and principal benefit that municipalities receive in the bankruptcy process is the automatic stay. Once the automatic stay is in place, all collection actions against the city must stop, including those by the city's own residents and officials.³² The stay provides the city breathing room for negotiating the reorganization of its debt.³³

A second benefit of the municipal bankruptcy process is that the city can obtain judicial confirmation of the debt reorganization plan without the agreement of all of its creditors.³⁴ As long as the plan is "fair and equitable" and one class of creditors accepts it, the bankruptcy court can compel all of the creditors to accept it.³⁵ This process of compulsory acceptance is known as the "cram down."³⁶

Another benefit of the municipal bankruptcy process is that cities retain substantial authority to govern during the pendency of the bankruptcy case.³⁷ This preservation of governing power is a product of Tenth Amendment considerations.³⁸ The city's ability to govern is most significantly preserved by the fact that there is no provision for a liquidation of municipal assets as part of the bankruptcy process.³⁹ Thus, the bankruptcy court cannot force a municipality to sell its inventory of police cars or fire trucks to pay its creditors.⁴⁰ In addition, the municipality can raise taxes and take on additional loans as administrative expenses during the bankruptcy proceeding.⁴¹ This ability is crucial when the city has no remaining assets.⁴²

Finally, unlike a Chapter 11 proceeding where the judge effectively controls most aspects of a business' affairs, the court in a Chapter 9 proceeding has little power to control the administration of municipal operations.⁴³ The presiding judge's authority extends to ruling on whether the petition should be granted, confirming the proposed debt reorganization plan, and overseeing the implementation of the confirmed plan.⁴⁴ If the city and the requisite subset of its creditors cannot come to an agreement on a reorganization plan, the bankruptcy court has no authority to impose any plan on the city and its creditors.⁴⁵

Of course, municipal bankruptcy brings significant detriments. The most obvious downside of municipal bankruptcy is that it harms the bankrupt city's reputation, making it harder for the city to convince new businesses or residents to locate there. For example, when Vallejo, Calif., entered the bankruptcy process, many of its residents and businesses left town.⁴⁶ The city is now in the position of trying to attract new residents by offering guided bus tours of foreclosed homes to anyone with a loan pre-qualification letter and a driver's license.⁴⁷

The reputational damage of a municipal bankruptcy can also extend to the city's credit rating. Many analysts have pointed out that bankruptcy will cause irreversible damage to a municipality's bond rating, thereby greatly impairing its ability to obtain future credit.⁴⁸ This effect of a bankruptcy should not be underestimated. In

2010, one ratings company, Fitch Ratings, threatened to downgrade the credit rating of municipalities that even *discussed* whether they should file for bankruptcy protection.⁴⁹ Indeed, this effect can spread like an infection. A Chapter 9 filing by one city can have a negative effect on neighboring cities and even on the state as a whole.⁵⁰ Bond rating agencies have also threatened to downgrade a state's credit rating if any of its municipalities file for bankruptcy.⁵¹

Although this risk of a long-term adverse credit impact is real, there are countervailing examples to suggest that a municipal bankruptcy might not doom a city's credit rating forever.⁵² After Orange County, Calif., went into bankruptcy, it obtained AA rating within months after the conclusion of its bankruptcy case.⁵³ This indicates that the most important thing about a municipal bankruptcy is the quality of the reorganization plan and the ultimate result achieved for creditors, not the simple filing of a bankruptcy case in itself. Evidence indicates that the credit rating agencies, and, more broadly, the credit markets are receptive to municipalities that have succeeded in rehabilitating their financial situation in bankruptcy.⁵⁴

There can be no doubt about another negative aspect of municipal bankruptcy: its cost. A Chapter 9 proceeding is very expensive and can use up municipal assets that could otherwise be paid to creditors or other stakeholders. In the bankruptcy case of Westfall, Pa., the city's attorney and account fees exceeded \$600,000.⁵⁵ And this was in a case where the city had only one creditor and where there was no appeal challenging the reorganization plan.⁵⁶

A couple of recent examples of municipal bankruptcies illustrate how these costs and benefits balance in concrete situations. When Vallejo, Calif., filed for Chapter 9 bankruptcy protection in May 2008, it faced significant limitations on municipal revenue⁵⁷ at the same time that its debt was expanding dramatically.⁵⁸ The bankruptcy process permitted the city to adjust compensation and benefits packages with city workers so that "city staffers now contribute more to their health insurance, new firefighters have lower pension plans, and the fire department no longer has minimum staffing requirements."⁵⁹ Even after the bankruptcy process ended, the city still imposes burdensome taxes on its citizens and businesses, public services remain "hollowed-out," and many neighborhoods still have numerous abandoned homes.⁶⁰ And the city still has to pay off the approximately \$8 million in legal fees that the city incurred during the bankruptcy process.⁶¹

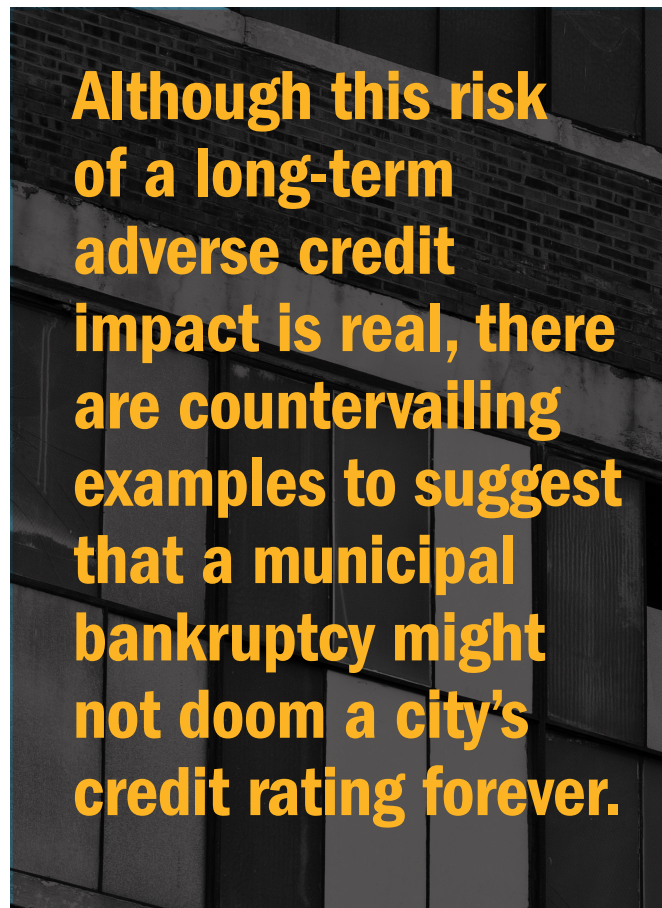
In Jefferson County, Ala., the county was propelled into bankruptcy by the economic effects of political corruption and by a default on municipal bonds issued to pay for water and sewer improvement projects.⁶² Even after bankruptcy, however, the county's sewer system still does not work, staffing for county services has been reduced to a bare-bones level, and the county still must pay off its debts.⁶³ As one county resident told a journalist, "Everyone wonders how the county will ever get out of this financial mess."⁶⁴

Part II. Detroit as an Illustration of the Unique Problems of Municipal Bankruptcy

As the Detroit case illustrates, the bankruptcy of a municipal government often follows a period of significant municipal economic success. This means that a city facing bankruptcy often has a legacy of economic commitments made during the good times, including and especially commitments to bondholders who funded municipal development projects and to pension funds for the municipal employees who helped to run the city when it was booming. Addressing those

commitments in a bankruptcy proceeding often involves difficult political and even moral questions that are not present in an ordinary personal or commercial bankruptcy.

As the nickname "Motor City" suggests, Detroit was once a pillar of the American economy and the core of the automobile industry in the United States. Since the 1960s, however, the city's economy has been in a precipitous decline. According to the state official in charge of shepherding Detroit through the bankruptcy process, "decades



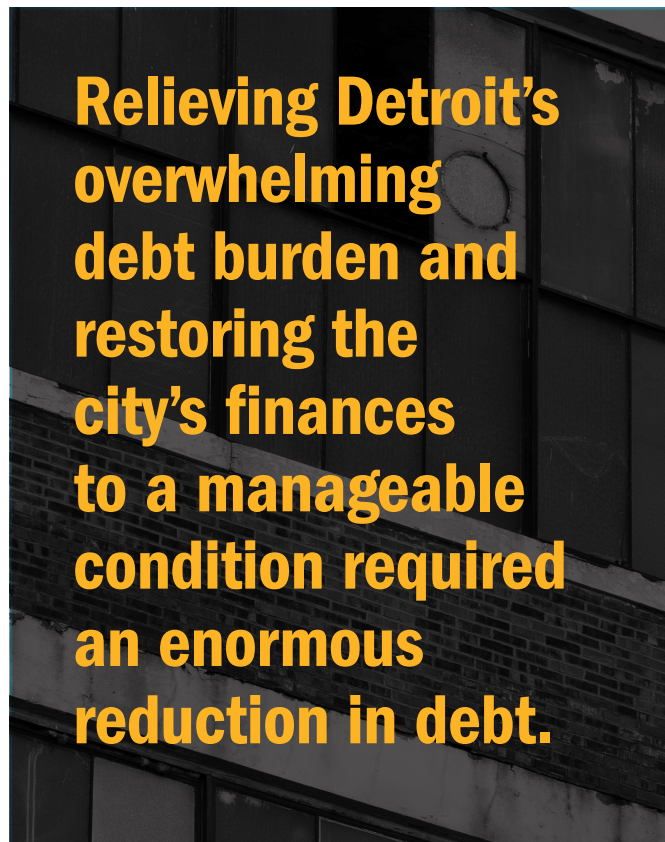
of fiscal mismanagement; plummeting population, employment, and revenues; decaying city infrastructure; deteriorating city services; and excessive borrowing that provided short-term Band-Aids at the cost of deepening insolvency" left the city of Detroit as a "shadow of the thriving metropolis that it once was."⁶⁵

Detroit's decline is most evident in the number of people and jobs in the city. Detroit's population has fallen 63 percent from its peak shortly after World War II, and 26 percent just since 2000.⁶⁶ "The number of jobs in Detroit (for residents and nonresidents) declined from 735,104 in 1970, to 562,120 in 1980, to 412,490 in 1990, to 346,545 in 2012."⁶⁷ By June 2012, the city's unemployment rate was 18.3 percent, having nearly tripled since 2000.⁶⁸

Economic conditions for Detroit residents have also declined rapidly, leaving Detroiters much less well off than their counterparts in the rest of Michigan. Between 2007 and 2011, the average per capita income in Detroit was \$15,261, while the average per capita income for Michigan was \$25,482.⁶⁹ During the same period, median household income in Detroit was \$27,862, while it was \$48,669 for the entire state.⁷⁰ The home ownership rate in Detroit was 54 per-

cent; it was 76 percent statewide.⁷¹ Thirty-six percent of Detroiters live below the poverty line; the comparable figure for Michigan is 16 percent.⁷²

The city's declining population and widespread economic hardship have left city government with little money. As its population decreased, as its properties were abandoned, and as its residents' incomes declined, the city's tax base eroded dramatically.⁷³ Detroit sought to compensate for its shrinking tax base by increasing its tax



rate, but, of course, a higher per-capita tax burden only adds to its resident's economic hardship.⁷⁴ The city's financial losses mean that city services are simply inadequate. The city is so cash-strapped that public services for residents and business are now severely inadequate.⁷⁵ For example, 40 percent of the city's streetlights do not work.⁷⁶ More significantly, when residents call the police, on average, they have to wait almost an hour for the officers to arrive; the national average response time for urban police forces is 11 minutes.⁷⁷ When police do work on a case, their clearance rate is substantially below the national average.⁷⁸

The toll taken by this economic decline is apparent everywhere in the city. Detroiters are not as safe as they once were. In 2012, the violent crime rate in Detroit was five times the national average; this was the highest rate in any U.S. city with a population above 200,000.⁷⁹ The city's homicide rate is higher than it has been in 40 years.⁸⁰ The city's physical appearance also reflects its overall decline. Detroit has 78,000 "abandoned and blighted" buildings and more than 140,000 blighted properties; among those blighted structures, 38,000 are considered dangerous.⁸¹

After decades of economic and population decline, Detroit was forced to file for bankruptcy under Chapter 9 of the United States

Bankruptcy Code, on July 18, 2013.⁸² The city's bankruptcy petition demonstrated how such decline could lead to overwhelming public debt. According to the petition, Detroit had more than 100,000 creditors, owing them a total of more than \$18 billion.⁸³ Of the total debt, \$11.9 billion was unsecured debt and \$6.4 billion was secured debt.⁸⁴ Broken down further, the city's debt included:

Approximately (a) \$5.85 billion in special revenue obligations; (b) \$6.4 billion in other post-employment benefits liabilities; (c) \$3.5 billion in underfunded pension liabilities based on current actuarial estimates; (d) \$1.13 billion in secured and unsecured general obligation liabilities; (e) \$1.43 billion in liabilities under pension-related certificates of participation (COPs); (f) \$295.5 million in swap liabilities related to the COPs; and (g) \$300 million in other liabilities.⁸⁵

The bankruptcy petition also pointed out that this debt burden was unsustainable. According to the petition, the debt service on Detroit's general obligations "consumed a staggering 42.5 percent of the city's revenues in the 2013 fiscal year."⁸⁶ The city estimated that this percentage would increase to 65 percent of revenues by 2017 in the absence of bankruptcy relief.⁸⁷

Relieving Detroit's overwhelming debt burden and restoring the city's finances to a manageable condition required an enormous reduction in debt. But the nature of the city's obligations made it much harder to effect such a reduction. In particular, there were two categories of Detroit's debt that were governed by legal rules making it much harder to reduce or eliminate the city's obligations: (1) pension obligations to the city's current and former employees and (2) municipal bonds, which were backed by the full faith and credit of the city. Figuring out how to reduce these debt obligations within the limits of the law was the crucial problem in Detroit's bankruptcy,⁸⁸ and it reflects the unique problems of municipal bankruptcies generally.

With respect to Detroit's pension obligations, the problem was that the Michigan Constitution provided specific and special protection to the pension plans of public employees. In particular, the Michigan Constitution provided that "the accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby."⁸⁹ More generally, the Michigan Constitution (like the U.S. Constitution) included a "Contracts Clause," which provides that "no ... law impairing the obligation of contract shall be enacted."⁹⁰ A variety of groups associated with Detroit's public employees argued that these two rules of state law precluded any diminution of the city's pension obligations.⁹¹

The problem of dealing with pension funds is complex, involving more than questions about whether the provisions of Chapter 9 give bankruptcy courts the authority to override certain state and federal rules protecting the interests of pension holders. There are important practical considerations relating to public employees' reliance on their pensions for retirement income. For example, certain public employees are not eligible for federal Social Security benefits and must rely entirely on their public pensions for retirement income.⁹² In addition, many public employee pension plans are not insured by the Pension Benefit Guarantee Corporation; this was true for both Detroit's police and fire pension plan and its pension plan for nonuniformed personnel.⁹³ As a result of these unique circumstanc-

es, adjusting municipal pension obligations through the bankruptcy process has more significant consequences for public employees than the adjustment of pension obligations for private employees.

With respect to the city's bond debt, the question arose about how to adjust Detroit's obligations in bankruptcy in light of the limitations on Detroit's ability to generate revenue through its taxing power.⁹⁴ In other words, the bankruptcy court had to make two important determinations before allowing Detroit to reduce its bond debt. First, it had to determine whether Detroit could generate enough tax revenue to pay its bond obligations, given that it was, at the time of the bankruptcy filing, levying taxes at the maximum rates allowed by law.⁹⁵ Making this determination required the bankruptcy court to consider whether Detroit's ability to direct its tax revenue to its bond debt would have been undermined by its other obligations, especially its pension obligations.⁹⁶ Second, the bankruptcy court had to determine whether the city's current economic conditions and future economic prospects would allow it to generate enough tax revenue to pay down its bond debt over the long term.⁹⁷

These questions had to be addressed at the outset of the case, as a matter of determining whether Detroit was eligible for bankruptcy protection at all.⁹⁸ On Dec. 5, 2013, the presiding judge, Hon. Steven Rhodes, issued a lengthy opinion to resolve these and other foundational questions.⁹⁹ With respect to the public employees' arguments under Michigan's Pension and Contracts Clauses, Judge Rhodes held that accrued pension benefits could be adjusted in Chapter 9 proceedings, notwithstanding the limitations imposed by the Michigan and U.S. Constitutions.¹⁰⁰ Similarly, Judge Rhodes held that the city's bond obligations could also be adjusted, even when those bond obligations were secured by special-purpose revenue streams or other methods of dedicating specific portions of the city's funds.¹⁰¹

In the final reorganization plan, Judge Rhodes faced an additional problem: how to balance the sacrifices that city employees and bondholders would have to make. Ultimately, Judge Rhodes concluded that the city's interest in protecting the welfare of its 32,000 employees, who provide essential services, was greater than the city's interest in its bondholders.¹⁰² In this connection, it was important to the court that the pre-bankruptcy pension benefits were so modest.¹⁰³ As the court noted, before the restructuring plan, Detroit's nonpublic safety workers were entitled to annual pension benefits of \$18,000; for public safety workers, who are ineligible for Social Security, the annual benefit was \$30,000.¹⁰⁴ In the end, current city employees were placed into a new retirement plan with reduced benefits, and former city employees agreed to a reduction in their benefits and in their cost-of-living increases.¹⁰⁵ With respect to the bondholders, the court held that they would have to accept even more significant cuts in the amounts they would receive.¹⁰⁶

Part III. Making Municipal Bankruptcy Less Frequent and Less Painful

Although the bankruptcy process may, in the final analysis, have more benefits than costs for a financially overwhelmed city, municipal bankruptcy still has consequences that are more harmful than good for those associated with the city, especially its employees, residents, and creditors. The challenge for cities is to avoid those negative consequences for their constituents and stakeholders. The obvious way to accomplish this objective is for cities to manage their finances so that bankruptcy is unnecessary. But, because financial crises are impossible to avoid entirely, it is not enough for cities to

simply strive to keep their books balanced. It is also necessary for city and state governments to plan for contingencies so that, on the rare occasion when bankruptcy is unavoidable, its detrimental effects can be mitigated. This section discusses several methods that cities and states can adopt to make municipal bankruptcy rare and less catastrophic for everyone involved.

Monitoring to Prevent Bankruptcy

Of course, the best way to prevent the negative consequences of municipal bankruptcy is to make sure that bankruptcies do not occur in the first place. Vigilance and sound planning by municipal officials are essential in this regard, but, as the recent spate of municipal bankruptcies has shown, it is not enough in itself. Cooperation between state and city officials can be crucially important, and one way to promote such cooperation is for state governments to provide financial monitoring for their city governments.¹⁰⁷ Such monitoring can reveal emerging financial problems that might escape the attention of local officials because it provides a second perspective on municipal finances.¹⁰⁸

Current approaches to financial monitoring at the state level are mixed. These various approaches to state monitoring reflect differing political opinions and traditions about the proper relationship between state and local governments.¹⁰⁹ In one sense, these differences about the proper extent of state supervision of city government are analogous to differences about the proper allocation of government power and responsibility between the state and federal governments. Just as there must be room for different opinions about federalism, it is important to recognize that there can—and should—be differences among the states about how they should construct their relationships with city governments.¹¹⁰ But even significantly different political traditions in this connection can accommodate a significant role for state governments in providing financial monitoring oversight to city governments.

Currently, 19 states provide some form of financial oversight for city governments.¹¹¹ All of these oversight systems provide that cities should furnish state government with data about certain key factors: the city's current assets and liabilities, its fund balances, information about flows of revenue and spending, debt amounts and types, economic conditions in the city, trends in demands for city services, and current and anticipated legal challenges that would involve significant costs and/or potential liabilities.¹¹² But these states differ significantly about what they do with this data. For example, Washington maintains a website at which each city's financial profile can be viewed,¹¹³ but it does not have any formal program authorizing a state agency to intervene or provide assistance if the posted data indicates a risk of municipal financial distress.¹¹⁴ Illinois follows a similar method for collecting data, but, like Washington, it has no procedure by which a state official monitors the data and provides advice or assistance when the data reveal a problem.¹¹⁵ In New York, the state comptroller is responsible for analyzing the data submitted by cities to produce a "stress score."¹¹⁶ Cities with high scores are offered financial management assistance by the state.¹¹⁷ In North Carolina, cities cannot issue bonds on their own; state government does it for them, and it will not issue any bond without an analysis of the city's financial health.¹¹⁸

Regardless of any state's political traditions regarding the relationship between state and city governments, it seems essential that states provide monitoring and analysis services for municipal fiscal

health.¹¹⁹ Such a monitoring system need not involve active management of city affairs by the state. But, at a minimum, states should ensure that cities have the analytical resources available to identify looming financial problems, and they should ensure that every municipality in the state is assessing its own financial health according to a shared set of metrics.

Pre-Planning for Post-Bankruptcy Recovery

It is axiomatic that a municipal bankruptcy only happens because a city has made significant mistakes in managing its financial resources or because a city has encountered profound economic problems outside the control of city officials. Once the bankruptcy process provides the adjustment and restructuring of municipal debt, it is essential that the city has a recovery plan that diminishes or eliminates the risk of a recurrence of the problems that prompted bankruptcy in the first place. As one municipal bankruptcy attorney noted, “Chapter 9 provide[s] the breathing room, [but] the recovery plan provides the resolution.”¹²⁰ Consequently, dealing effectively with bankruptcy means that, before bankruptcy is even a possibility, state governments should identify a method by which cities in financial distress can develop a recovery plan.

The Detroit experience offers an example of how to establish such a method for developing a recovery plan. In the wake of the Detroit bankruptcy, Michigan state government prescribed a financial structure that the city would have to implement on a going-forward basis.¹²¹ This structure included the establishment of a financial review commission that would oversee the implementation of the post-bankruptcy recovery plan. The commission was designed to act as an independent watchdog over city finances, ensuring that the localized political pressures did not undermine sound, long-term financial management for the city. In approving Detroit’s debt reorganization plan, the bankruptcy court noted: “It cannot be emphasized enough that the long-term feasibility of the plan of adjustment will depend on the effectiveness of the Financial Review Commission. This is a matter of extraordinary weight and responsibility.”¹²²

Having an independent decision-maker in a position to review financial performance and supervise fiscal choices means that the city’s post-bankruptcy fiscal policy will be insulated from political considerations, at least to a certain extent. The value of this kind of independent oversight means that the preservation of the city’s fiscal health will be a pre-eminent consideration in decisions about municipal spending and revenue. The city will not be in a position where this value will not be overwhelmed by the immediate needs of certain constituencies, as expressed through the political process.

Where this kind of independent oversight is missing, cities can slip back into financial distress. Recent events in Vallejo show how problematic this can be. When Vallejo went into bankruptcy in 2008, the burgeoning costs of salaries and retirement benefits for police and firefighters were a key cause of the city’s fiscal distress.¹²³ In the city’s debt reorganization plan, Vallejo significantly reduced these costs, and this reduction was essential to the preservation of the city’s future financial health.¹²⁴ But once the bankruptcy process was over, the California Public Employees’ Retirement System, the state’s public pension entity, began asking for higher contributions from local governments each year. Vallejo’s most recent annual financial report indicates increasing distress, largely because of these growing payments, which could exceed 60 percent of the city’s payroll costs by 2016.¹²⁵ This problem could have been mitigated or avoided with

better coordination at the level of state government and a better method for dealing with contingencies that placed stress on the city’s fragile financial health in the wake of its bankruptcy.

Setting Priorities and Balancing Obligations

Another important consideration in preventing municipal bankruptcy is the establishment of financial priorities among all of the constituencies who rely on payments from cities. In particular, establishing such priorities means figuring out how to balance the competing claims of employees and bondholders.¹²⁶ This balance is important as a means of setting the expectations of those constituencies before bankruptcy is even on the horizon. In addition, having such priorities set as a matter of state law can make it easier for cities to accommodate the competing claims of those groups in its annual budgeting process. If the employees and bondholders know, at least in a general sense, how their interests will be affected by a city’s insolvency, they will be more likely to accept compromises before such an insolvency occurs. Without this kind of foreseeability, constituents might each have an incentive to avoid compromise and risk propelling the city into bankruptcy, hoping that they could prevail in vindicating their interests over and above competing groups through the bankruptcy process. Since the Detroit bankruptcy was led in 2013, California, Michigan, Nebraska, and Illinois lawmakers have considered legislation that would spell out the order of payment in certain instances, with preferential treatment given to bondholders.¹²⁷ The important part of this legislation is not that it would privilege bondholders; it is that it would establish a priority that would shape the outcome of bankruptcy and create reliable expectations that could guide conduct and negotiations when a city began to contemplate bankruptcy.

Alternatives to Bankruptcy

Another problem that has contributed to the occurrence of municipal bankruptcies is the lack of alternative procedures that cities and their creditors can employ when the city begins to suffer financial problems. When financial problems first occur, employees, bondholders, and others with an important stake in the city all compete for the city’s increasingly scarce revenue resources. In many cases, when bankruptcy itself is the only means of resolving conflicts, this competition occurs in the context of the city’s political process; and if the political process fails, there is nowhere left to turn but the bankruptcy court. But if there are alternative means of resolving conflict other than the city’s political process and the bankruptcy court, compromises can be reached through less costly and painful means than municipal bankruptcy.

Several states have developed programs designed to help their cities better manage their finances and to head off a municipal financial crisis before it occurs. For example, since 1987, Pennsylvania has had legislation creating a program to assist financially troubled local governments in avoiding insolvency.¹²⁸ But entering this program has often proven to be a one-way street; of the 27 local governments that have entered the program, only seven met the conditions to leave it.¹²⁹ In 2014, the state’s legislature set an eight-year limit for a city to be in the program, and it allowed local governments to raise a payroll tax to generate additional revenue.¹³⁰

Michigan has had an intervention program for financially troubled cities since 1990.¹³¹ Under this program, the governor had the authority to appoint an emergency manager for cities in financial distress, and this manager had extensive authority to control the

financial (if not the political) functions of city government.¹³² In 2012, Michigan changed this program to allow cities to choose a mediator or bankruptcy filing as an alternative to an emergency manager.¹³³

Rhode Island has an incremental process for helping cities emerge from financial problems.¹³⁴ The process begins when the state appoints an emergency manager. If that does not resolve the problems, a budget commission is established for the city; the appointment of a receiver is the last resort.¹³⁵ A city must complete all three parts of this process before obtaining state authorization to file for bankruptcy.¹³⁶

Other states take different approaches, many of which are quite modest, sometimes consisting primarily of mediation services designed to help resolve political conflicts or facilitate negotiation between a city and its creditors.¹³⁷ But the important lesson is to have a state-authorized process that can be activated when a city begins to suffer financial distress but is not yet in a position where a bankruptcy filing would be necessary or advisable.

Conclusion

In a sense, a city is like a battleship or an aircraft carrier—an enormous entity that moves slowly and adjusts its course even more slowly and over a great distance. When economic exigencies arise that make an established course problematic, the city has to change directions, but it cannot turn on a dime. In many cases, like Detroit's, a city facing long-term economic problems recognized the need for a change of direction but lacked the capacity to do so readily and eventually steamed straight into bankruptcy. City and state governments must develop instruments that can help cities detect the need for a course change at the first opportunity and that can make it somewhat easier for the city to chart a new financial course so that it can avoid bankruptcy altogether. ☺



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Endnotes

¹U.S. CONST. art. I, § 8, cl. 4.

²Francisco Vazquez, *Examining Chapter 9 Municipal Bankruptcy Cases*, in CHAPTER 9 BANKRUPTCY STRATEGIES: LEADING LAWYERS ON NAVIGATING THE CHAPTER 9 FILING PROCESS: COUNSELING MUNICIPALITIES, & ANALYZING RECENT TRENDS & CASES 173, 176-77 (2011).

³U.S. CONST. amend. X.

⁴Vazquez, *supra* note 2, at 177.

⁵Leon R. Barson & Francis J. Lawall, *Chapter 9 Bankruptcy: Restructuring Municipalities in Financial Distress*, in CHAPTER 9 BANKRUPTCY STRATEGIES: LEADING LAWYERS ON NAVIGATING THE CHAPTER 9 FILING PROCESS: COUNSELING MUNICIPALITIES, & ANALYZING RECENT TRENDS & CASES 7, 16-17 (2011).

⁶11 U.S.C. §§ 901, et seq.

⁷Daniel J. Freyberg, *Municipal Bankruptcy and Express State Authorization to be a Chapter 9 Debtor: Current State Approaches to Municipal Insolvency—and What Will States Do Now?*, 23 OHIO

N.U. L. REV. 1001, 1011 (1997).

⁸*Ashton v. Cameron Cty. Water Improvement Dist.*, 298 U.S. 513, 533-34 (1936) (Cardozo, J., dissenting).

⁹Keeok Park, *To File or Not to File: The Causes of Municipal Bankruptcy in the United States*, J. PUB. BUDGETING, ACCT. & FIN. MGMT. (July 1, 2004), at 228; see also Melanie Cyganowski, *Guest Words: Muni World Needs to Grasp the Basics of Chapter 9*, BOND BUYER (Aug. 30, 2010) at 6.

¹⁰*Ashton*, 298 U.S. at 530.

¹¹*United States v. Bekins*, 304 U.S. 27, 54 (1938); see also Freyberg, *supra* note 7, at 1003-4.

¹²Freyberg, *supra* note 7, at 1003-4.

¹³Robin Jeweler & Cong. Research Serv., RL 33924, *Municipal Reorganization: Chapter 9 of the U.S. Bankruptcy Code* 3 (2007). A large municipality like New York City generally has hundreds, if not thousands, of creditors. It could hardly be expected to successfully negotiate with a majority of its creditors. “Thus, the primary relief generally sought by a debtor—the breathing spell from its importuning and litigious creditors provided by the bankruptcy automatic stay—was unavailable when needed most by the beleaguered city.” COLLIER ON BANKRUPTCY ¶ 900.LH (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2011).

¹⁴Freyberg, *supra* note 7, at 1004.

¹⁵Christopher Smith, *Provisions for Access to Chapter 9 Bankruptcy: Their Flaws and the Inadequacy of Past Reforms*, 14 BANKR. DEV. J. 497, 499 (1998).

¹⁶Kenneth E. Noble & Kevin M. Baum, *Municipal Bankruptcies: An Overview and Recent History of Chapter 9 of the Bankruptcy Code*, INSOLVENCY & RESTRUCTURING ADVISORY (July 23, 2013), available at https://www.kattenlaw.com/files/45320_Municipal%20Bankruptcies%20An%20Overview%20and%20Recent%20History%20of%20Chapter%209%20of%20the%20Bankruptcy%20Code.pdf (last visited Jan. 8, 2017). According to Noble & Baum, the states that allow local governments to file for bankruptcy protection without conditions are Alabama, Arizona, Arkansas, Idaho, Minnesota, Missouri, Montana, Nebraska, Oklahoma, South Carolina, Texas, and Washington. The states that allow Chapter 9 filing but with certain conditions are California, Connecticut, Florida, Kentucky, Louisiana, Michigan, New Jersey, New York, North Carolina, Ohio, Pennsylvania, and Rhode Island. *Id.* Interestingly, other commentators have different counts of the states that do and do not require certain conditions to be fulfilled before a city can file for bankruptcy. See Thomas Hoffman, Comment, *Municipal Bankruptcy Authorization under Chapter 9: A Call for Uniformity Among States*, 34 ST. LOUIS U. PUB. L. REV. 215, 222-23 (2014) (discussing scholarship on municipal bankruptcy law).

¹⁷Hoffman, *supra* note 16, at 222.

¹⁸*Id.*

¹⁹James E. Spiotto, *The Role of the State in Supervising and Assisting Municipalities, Especially in Times of Financial Distress*, 33 MUN. FIN. J. 1, 28 (2013).

²⁰These requirements are set forth in 11 U.S.C. § 109(c).

²¹11 U.S.C. § 101(40) (2006). Because the code does not provide a more extensive elaboration of what entities are included within the meaning of this statutory definition, the courts have concluded that an entity is a “municipality” if it is subject to the control of state or municipal public authority. See, e.g., *In re Las Vegas Monorail Co.*, 429 B.R. 317, 323 n.1 (Bankr. D. Nev. 2010). States have also estab-

lished their own definitions of “municipality” to be consistent with this federal authority, as they set forth the conditions under which municipalities can file bankruptcy. *See* Park, *supra* note 9.

²²11 U.S.C. § 109(c)(3).

²³11 U.S.C. § 109(32)(c).

²⁴11 U.S.C. § 109(c)(2).

²⁵11 U.S.C. §§ 109(c)(4)-(5).

²⁶11 U.S.C. § 109(c)(4).

²⁷*See id.*

²⁸11 U.S.C. § 109(c)(5).

²⁹11 U.S.C. § 941.

³⁰11 U.S.C. § 922.

³¹11 U.S.C. § 945.

³²11 U.S.C. § 922.

³³Jeweler, *supra* note 13, at 6.

³⁴*Id.* at 9. Under the bankruptcy code, a “class of creditors” is a group of creditors who are entitled to similar treatment in the case.

³⁵*See* 11 U.S.C. § 901(a) (incorporating the “cram down” provision of 11 U.S.C. § 1129(b)(1)).

³⁶*See id.*

³⁷COLLIER, *supra* note 13, at ¶ 900.01(1); Freyberg, *supra* note 7, at 1001.

³⁸COLLIER, *supra* note 13, at ¶ 900.01(1).

³⁹*Id.*

⁴⁰*Id.*

⁴¹*Id.* at ¶ 900.01(2).

⁴²*Id.*

⁴³*Id.* at ¶ 900.01(2)(c).

⁴⁴*Id.* at ¶ 900.01(1).

⁴⁵*Id.*

⁴⁶Helen Avery, *Judgement Day Nears for the Benighted States*, EUROMONEY (Sept. 2010), available at <http://www.euromoney.com/Article/2673015/Judgement-day-nears-for-the-benighted-states.html> (last visited Jan. 8, 2017).

⁴⁷*Id.*

⁴⁸Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 383-84 (2010).

⁴⁹Peter Benvenutti, et al., *An Overview of Chapter 9 of the Bankruptcy Code: Municipal Debt Adjustments*, MONDAQ (Aug. 23, 2010), available at <http://www.mondaq.com/unitedstates/x/108258/Insolvency+Bankruptcy/An+Overview+of+Chapter+9+of+the+Bankruptcy+Code+Municipal+Debt+Adjustments> (last visited July 31, 2016).

⁵⁰Kimhi, *supra* note 48, at 382-83.

⁵¹*Id.* at 383.

⁵²Benvenutti, et al., *supra* note 49, at 9.

⁵³Lauren M. Wolfe, *The Next Financial Hurricane? Rethinking Municipal Bankruptcy in Louisiana*, 72 LA. L. REV. 555, 557 (2012).

⁵⁴*Id.*

⁵⁵J. Gregg Miller, *The Pros and Cons of Chapter 9 Bankruptcy*, PENNLIVE.COM (May 16, 2010), available at http://www.pennlive.com/editorials/index.ssf/2010/05/pros_and_cons_of_chapter_9_ban.html (last visited Jan. 8, 2017).

⁵⁶*See id.*

⁵⁷Some of the limitations on revenue in Vallejo were connected to the declining value of mortgage-backed securities that peaked with the economic crisis of 2008. Many municipalities participate in invest-

ment pools that are heavily invested in a variety of securities that were linked to mortgage-backed securities in one way or another. When the value of the securities decline precipitously, municipal investments designed to benefit pension funds and other municipal programs suffered. *See* FINANCIAL CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT 254 (2011), available at <https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf> (last visited Jan. 8, 2017).

⁵⁸*See In re City of Vallejo*, 403 B.R. 72 (Bankr. E.D. Cal. 2009), *aff’d*, 432 B.R. 262 (E.D. Cal. 2010); *see also* Carolyn Jones, *Vallejo’s Bankruptcy Ends After 3 Tough Years*, SFGATE (Nov. 1, 2011), available at <http://www.sfgate.com/bayarea/article/Vallejo-s-bankruptcy-ends-after-3-tough-years-2324840.php> (last visited Jan. 8, 2017).

⁵⁹Jones, *supra* note 58.

⁶⁰Bobby White, *Scars of Bankruptcy Linger in Vallejo*, WALL ST. J. (Jan. 19, 2012), available at <http://www.wsj.com/articles/SB10001424052970204555904577167013455352608> (last visited Jan. 8, 2017).

⁶¹*Id.*

⁶²Christine Sgarlata Chung, *Municipal Securities: The Crisis of State and Local Government Indebtedness, Systemic Costs of Low Default Rates, and Opportunities for Reform*, 34 CARDOZO L. REV. 1455, 1481-84 (2013).

⁶³*See, e.g.*, Mary Williams Walsh, *In Alabama, a County That Fell Off the Financial Cliff*, N.Y. TIMES (Feb. 18, 2012), available at http://www.nytimes.com/2012/02/19/business/jefferson-county-ala-falls-off-the-bankruptcy-cliff.html?_r=0 (last visited Jan. 8, 2017).

⁶⁴*Id.*

⁶⁵*See, e.g.*, Decl. of Kevyn D. Orr in Supp. of the City of Detroit, Michigan’s Statement of Qualifications Pursuant to Section 109(c) of the Bankruptcy Code at 4-5, *In re City of Detroit, Mich.*, Case No. 13-53846, (Bankr. E.D. Mich. July 18, 2013), ECF No. 11 (“Orr Declaration”). For a further description of Detroit’s decline, *see also* Opinion Regarding Eligibility at 20-22, *In re City of Detroit, Michigan*, No. 13-53846, 2013 WL 6331931, at *20-22 (Bankr. E.D. Mich. Dec. 5, 2013) (“Opinion Regarding Eligibility”).

⁶⁶Orr Declaration, *supra* note 65, at 13-14.

⁶⁷*Id.* at 20 (citations omitted).

⁶⁸*Id.*

⁶⁹*Id.* at 17.

⁷⁰*Id.*

⁷¹*Id.*

⁷²*Id.*

⁷³*See id.* at 16-20.

⁷⁴*See id.* at 16-20.

⁷⁵*See id.* at 21-24.

⁷⁶*See id.*

⁷⁷*Id.* at 12; Opinion Regarding Eligibility, *supra* note 65, at *12.

⁷⁸Orr Declaration, *supra* note 65, at 22-23; Opinion Regarding Eligibility, *supra* note 65, at *12.

⁷⁹*See e.g.*, Opinion Regarding Eligibility, *supra* note 65, at *12.

⁸⁰*See, e.g.*, Statement of Qualifications Pursuant to Section 109(c) of the Bankruptcy Code, at 12, *In re City of Detroit, Mich.*, No. 13-53846, (Bankr. E.D. Mich. July 18, 2013), ECF No. 10 (“Statement of Qualifications”).

⁸¹*See* Memorandum in Support of Statement of Qualifications Pursuant to Section 109(c) of the Bankruptcy Code at 25, *In re City of Detroit, Mich.*, No. 13-53846, (Bankr. E.D. Mich. July 18, 2013), ECF No. 14 (“Memorandum in Support of Statement of Qualifica-

tions”); Nick Carey, *Detroit Blight Battle to Take Down Abandoned Buildings Could Be Key to Bankrupt City’s Survival*, HUFFINGTON POST (updated Sept. 24, 2013), available at http://www.huffingtonpost.com/2013/07/25/detroit-blight-abandoned-buildings-bankrupt-_n_3651224.html (last visited Jan. 8, 2017). Abandoned and blighted structures constitute 20 percent of the city’s housing stock. *See id.*

⁸²See Chapter 9 Voluntary Petition, *In re City of Detroit, Mich.*, No. 13-53846 (Bankr. E.D. Mich. July 18, 2013), ECF No. 1.

⁸³Memorandum in Support of Statement of Qualifications, *supra* note 81, at 44; *see also* Opinion Regarding Eligibility, *supra* note 65, at *5.

⁸⁴Opinion Regarding Eligibility, *supra* note 65, at *5.

⁸⁵*Id.* at *7.

⁸⁶Memorandum in Support of Statement of Qualifications, *supra* note 81, at 3. These general obligation debts did not include debts that were secured by dedicated revenue streams. *Id.*

⁸⁷*Id.*

⁸⁸See Opinion Regarding Eligibility, *supra* note 65.

⁸⁹MICH. CONST. art. IX, § 24 (“the Pension Clause”).

⁹⁰*Id.*, art. I, § 10.

⁹¹See, e.g., Objection of the Detroit Retirement Systems to the Motion of Debtor for Entry of an Order (I) Authorizing the Assumption of that Certain Forbearance and Optional Termination Agreement Pursuant to section 365(c) of the Bankruptcy Code, (II) Approving such Agreement Pursuant to Rule 9019 and (III) Granting Related Relief, *In re City of Detroit, Mich.*, No. 13-53846, (Bankr. E.D. Mich. Aug. 16, 2013), ECF No. 370; Consolidated Objection of the Retiree Association Parties to Eligibility, *In re City of Detroit, Mich.*, No. 13-53846, (Bankr. E.D. Mich. Aug. 19, 2013), ECF No. 497.

⁹²See Paul M. Secunda, *Constitutional Contracts Clause Challenges in Public Pension Litigation*, 28 HOFSTRA LAB. & EMP. L.J. 263, 263-71 (2011).

⁹³See Opinion Regarding Eligibility, *supra* note 65, at 6.

⁹⁴Opinion Regarding Eligibility, *supra* note 65.

⁹⁵See *id.*

⁹⁶See *id.*

⁹⁷See *id.*

⁹⁸See *id.*

⁹⁹See *id.*

¹⁰⁰See *id.* at 41-44.

¹⁰¹See *id.*

¹⁰²Bankruptcy Judge Steven Rhodes, Oral Opinion on the Record, *In re City of Detroit* (Nov. 7, 2014), available at <https://www.mied.uscourts.gov/PDFFiles/DBOralOpinion.pdf> (last visited Jan. 8, 2017).

¹⁰³*Id.*

¹⁰⁴*Id.*

¹⁰⁵*Id.*

¹⁰⁶*Id.*

¹⁰⁷The Pew Charitable Trusts, *After Municipal Bankruptcy: Lessons From Detroit and Other Local Governments* 10-11 (Aug. 12, 2015), available at <http://www.pewtrusts.org/en/research-and-analysis/reports/2015/08/after-municipal-bankruptcy> (last visited Jan. 8, 2017).

¹⁰⁸*Id.*

¹⁰⁹See *id.*

¹¹⁰See *id.* at 10.

¹¹¹The Pew Charitable Trusts, *The State Role in Local Government Financial Distress* (July 2013), available at http://www.pewtrusts.org/~media/Assets/2013/07/23/Pew_State_Role_in_Local_Government_Financial_Distress.pdf (last visited Jan. 8, 2017).

¹¹²*Id.*

¹¹³See Office of Washington State Treasurer, *Washington State Local Government Financial Health Indicators* (Aug. 2010), available at <http://www.tre.wa.gov/documents/localGovtFiscalReport.pdf> (last visited Jan. 8, 2017).

¹¹⁴After *Municipal Bankruptcy*, *supra* note 107, at 11.

¹¹⁵*Id.*

¹¹⁶*Id.*

¹¹⁷*Id.*

¹¹⁸*Id.*

¹¹⁹*Id.*

¹²⁰James Spiotto, *Lessons Learned From the Detroit Bankruptcy*, MUNINET GUIDE (Nov. 10, 2014), available at <http://muninetguide.com/lessons-learned-from-the-detroit-bankruptcy> (last visited Jan. 8, 2017).

¹²¹After *Municipal Bankruptcy*, *supra* note 107, at 6.

¹²²Rhodes, *supra* note 102.

¹²³After *Municipal Bankruptcy*, *supra* note 107, at 6-7.

¹²⁴*Id.*

¹²⁵*Id.*

¹²⁶*Id.* at 9.

¹²⁷Kyle Glazier, *New California Law Would Secure Local GO Holders in Bankruptcies*, BOND BUYER (July 17, 2015), available at <http://www.bondbuyer.com/news/regionalnews/new-california-law-would-secure-local-go-holders-in-bankruptcies-1079376-1.html> (last visited Jan. 8, 2017).

¹²⁸After *Municipal Bankruptcy*, *supra* note 107, at 11.

¹²⁹Paul Burton, *Pennsylvania to End “Roach Motel” Stays for Distressed Cities*, BOND BUYER (Oct. 16, 2014), available at <http://www.bondbuyer.com/news/regionalnews/pennsylvania-to-end-roach-motel-stays-for-distressed-cities-1067045-1.html> (last visited Jan. 8, 2017).

¹³⁰*Id.*

¹³¹After *Municipal Bankruptcy*, *supra* note 107, at 11.

¹³²*Id.*

¹³³*Id.*

¹³⁴*Id.*

¹³⁵*Id.*

¹³⁶*Id.*

¹³⁷See *id.*